COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, MAY 14, 1999

APPLICATION OF

VIRGINIA ELECTRIC AND
POWER COMPANY CASE NO. PUE980462

For Approval of Expenditures
for New Generation Facilities
pursuant to Va. Code § 56-234.3 and
for a certificate of public
convenience and necessity pursuant to
Va. Code § 56-265.2

ORDER

On August 11, 1998, Virginia Electric and Power Company ("Virginia Power" or "Company") filed an application (the "Application"), requesting regulatory approval for the construction of new gas-fired turbine generator units ("CTs"). Each unit produces approximately 150 megawatts ("MW"). The Company requested permission to install the units either at a site in Caroline County or a site in Fauquier County. A related application seeks regulatory approval for construction of transmission facilities necessary to connect these generators to the electric transmission grid. Following amendments to the Application, Virginia Power seeks authority to construct four CTs at its Fauquier County site.

On September 2, 1998, the Commission Staff ("Staff") moved for a ruling as to whether the Rules Governing the Use of

Bidding Programs to Purchase Electricity from Other Power Suppliers, now codified at 20 VAC 5-301-10 ("Rules"), were applicable to Virginia Power's filings. The Company responded, arguing that either the Rules did not apply to it, for various reasons, or that it should be granted an exemption from the Rules. A number of other parties filed responses as well.

On January 5, 1999, the Commission heard the case. On January 14, 1999, we entered an Order in which we found that the Rules applied and that Virginia Power should not be granted an exemption from them. During the hearing, the Company revealed that it intended to issue a solicitation for 264 MW of the 864 MW needed for delivery by July 1, 2000, but sought exemption from bidding the remaining increment. We were not persuaded from the evidence that a solicitation for the 600 MW of capacity represented by the units the Company proposed to build could not also occur. Delivery of both increments of capacity will fall due on the same date.

Therefore, we directed Virginia Power to conduct a competitive solicitation for bids for the entire increment of power it sought for delivery in the year 2000. At its option, Virginia Power could solicit for the power it planned to acquire for the years 2001 and 2002 as well. The Order set out certain terms and conditions the Company was required to meet in conducting its solicitation.

The Company was ordered to compare any offers it received against the benchmark cost of its proposed units as set out in its Application, as amended. We agreed with Virginia Power that non-price factors should be weighed less heavily than in earlier solicitations. However, we stated that supply reliability is an appropriate non-price factor for consideration. "Iron in the ground" within the Company's control area could be viewed as more reliable than unspecified firm energy proposals.

Further, as several parties and the Staff requested, we found that mitigation of Virginia Power's market power was another important non-price factor for consideration. We considered the presence of other providers able to supply the necessary capacity at a price equal or superior to that of Virginia Power to be in the public interest, as this would help to moderate the amount of market power Virginia Power could continue to exercise as the Commonwealth makes the transition from a fully regulated to a more competitive generation market. Nonetheless, we viewed reliability of service to be the more significant non-price factor to be considered. We granted exemption from consideration of additional non-price factors, to the extent such consideration was mandated by the Rules.

Because we found that additional capacity is needed in the summer of 2000, the Commission granted conditional authority to Virginia Power to make financial expenditures, pursuant to § 56-

234.3 of the Code of Virginia, for the four units in Fauquier County. The Company was ordered and directed to begin necessary permitting work and to maintain its control and ownership of the CTs it had secured from the manufacturer in contemplation of its proposed construction. The approvals were conditioned upon the Company's proper conduct of the competitive solicitation and the bid producing no superior offers of capacity.

March 26, 1999, marked the close of the bidding window. On that day, the Staff witnessed the opening of the bids, which had previously been sealed. Thereafter, the Company analyzed the bids received and submitted its analysis to the Staff for its review. The Staff filed a report of its own analysis and review of the bids on April 2, 1999, in both public and proprietary versions. On April 16, 1999, comments on the Staff report were filed by one protestant, Dynegy Power Corp.

The Staff report concludes that Virginia Power should be allowed to proceed with construction of the Fauquier County units. The report expresses the Staff's continued concern with the market power implications of the recommendation, but concludes that construction of the units is necessary for maintenance of system reliability.

The report finds that a number of reasonable offers were received, but not in an amount both sufficiently reliable and competitively priced to supplant completely the Company's

construction of the units. The Company rejected some offers because of uncertainties about the effects of the proposals on existing environmental permits. One bid containing favorable prices, but based on deployment of unspecified distributed generation facilities, was rejected as being incomplete.

The Staff report concludes that Virginia Power should be permitted to construct the units subject to some restrictions. First, the Staff recommends that in its earnings tests filings for the period 2000-2006 the Company should use the same annual fixed revenue requirements for the units as it used in its bid analysis, rather than the actual revenue requirements associated with the units. Second, the Staff recommends that Virginia Power be directed to account separately for the fixed costs of the units to facilitate appropriate accounting adjustments.

NOW THE COMMISSION, having considered the Staff's report, the pleading filed in response, the record herein and the applicable statutes and rules, is of the opinion and finds that Virginia Power has complied with the directives of the Order, has conducted a solicitation for competitive bids to supply the identified capacity need for July 2000, and has appropriately analyzed the bids received. Because the Company retains the obligation to serve within its designated service territory, and we are convinced from the record that additional capacity is

needed by the Summer of 2000, we will permit Virginia Power to construct the units.

We are also convinced upon the record before us that the Company now has, and will continue to have, the ability to exercise market power over the generation and supply of electricity in a large portion of the Commonwealth. The Commission finds that while Virginia Power has developed an economical and efficient program for meeting its identified capacity needs, the program increases the Company's market power and makes generation competition more difficult and less likely to develop. The Company should continue to negotiate with bidders to fulfill the remaining 264 MW increment of capacity necessary for delivery by July 2000 and continue to consider all offers received for capacity to be delivered in 2001 and 2002. Virginia Power has indicated that it will obtain all capacity for these later years from the market and doing so should serve to retard its ability to exercise market power to a degree. We direct the Company to take promptly all steps necessary to secure market supplied capacity for delivery in 2001 and 2002.

The conditional authority to make expenditures for construction of generating facilities, granted in our Order of January 14, 1999, should be, and is, made final and the Company is authorized to make such expenditures for its construction of the units in Fauquier County.

We are granting these certificates of public convenience and necessity reluctantly, as we believe the record demonstrates that the Company now has substantial market power over the provision of electric utility service within its current service territory, and will continue to possess such market power for the foreseeable future.

The 1999 Session of the Virginia General Assembly enacted the Electric Utility Restructuring Act ("Act"),[1] which will bring sweeping changes in the structure of the Commonwealth's electric utility industry. The new law[2] will set aside the policy that required the Commission to establish and protect the integrity of the service territories within which the Commonwealth's electric utilities provided integrated electric service, i.e., the combined generation, transmission and distribution of power to Virginians. In exchange for service territory protection, those utilities were obligated to serve, at regulated rates, any and all customers within those areas that desired service.

The new law opens the generation market and foresees competition as the prime regulator of the price of the generation component of electricity. For the law to work as intended, there must be many generators or other suppliers ready

[1] Section 56-576 et seq. of the Code of Virginia, effective July 1, 1999.

[2] The 1998 Session of the General Assembly began the Commonwealth's course toward a competitive retail market for electricity in enacting HB 1172.

and able to provide the electricity needs of customers, and willing to compete for business on the basis of price, service, or other factors. If competition is to establish prices in a fair and reliable manner, there must be competitors in the field.

The Act establishes the timeframe within which and many of the conditions upon which the Commission is directed to manage the transition from rate-regulated to market-regulated utility service. We believe that, all things being equal, the new public policy of the Commonwealth would favor the awarding of the contracts to supply the required generating capacity to entities other than Virginia Power. Doing so would establish the presence of other generation suppliers within the Commonwealth as the transition from regulated to competitively priced generation of electricity is made.

But, we cannot find that all things are equal in this case. Virginia Power did not solicit bids in a timely manner as required by the Bidding Rules. The solicitation that it made pursuant to our Order of January 14, 1999, did not develop bids superior to its planned construction. Under this unfortunate constraint, Virginia Power's proposal provides the best price to supply the necessary capacity in a timely and reliable manner. We are granting the Company certificates of public convenience

and necessity under the Utility Facilities Act[3] to construct the units *because the convenience of the public* makes it necessary for Virginia Power to do so. We have found that the units are needed to meet the service needs of customers that currently are served by Virginia Power. We will also adopt the recommendations from the Staff report referenced above.

The Act will authorize the Commission to take certain actions necessary to mitigate market power. Incumbent electric utilities should be on notice that the Commission will take all necessary actions to mitigate market power, to ensure that the operation of the generating units of incumbent utilities will not inhibit the development of competition within the Commonwealth, and to carry out the purposes of the new law.

On May 12, 1999, the Commission received a filing from the Piedmont Environmental Council ("Piedmont"), requesting leave to intervene and to participate as protestants herein. The record indicates that the Company published appropriate public notice of its application and the hearing herein. We will deny this motion because it was received well after the filing date and the noticed hearing. Further, the record includes, as part of our compliance with § 56-46.1, a letter from the Department of Environmental Quality ("DEQ"), stating that DEQ coordinated a

[3] Section 56-265.1 et seq. of the Code of Virginia.

review of the project by all affected state agencies and localities and that none of the reviewing entities objected to the proposed project. The DEQ letter does not constitute that agency's approval of construction, however, so Piedmont may raise its arguments regarding air quality to the DEQ in the permitting process there. Piedmont has not shown good cause to permit its belated entry into the proceedings before us.

As stated, we are approving the construction of the units so that needs of customers now served by Virginia Power can be timely and reliably met in the future, and we may impose conditions upon their future operation that become necessary to ensure that our approval is not detrimental to the development of competition, as directed by the General Assembly.

Accordingly, IT IS ORDERED THAT:

(1) Virginia Power is authorized to construct four combustion turbine generating units at its location in Fauquier County, Virginia, named in its application, pursuant to Code § 56-265.2;

(2) Virginia Power's authorization, pursuant to Code § 56-234.3, to make financial expenditures for said construction, granted conditionally in the Commission's Order of January 14, 1999, is made final;

(3) Virginia Power shall use the annual fixed revenue requirements set out in the Staff report for purposes of its

earnings test filings for the period 2000-2006, and shall account separately for the fixed costs of the units to facilitate appropriate accounting adjustments;

(4) The Motion to Intervene and Request to Participate as Protestants filed by Piedmont is denied; and

(5) There being nothing further to come before the Commission in this proceeding, this case shall be removed from the docket and the papers transferred to the file for ended causes.